

on a return to which section 6661 applies (see paragraph (b) of § 1.6661-1 and paragraph (d)(2)(iv) of § 1.6661-2), disclosure is adequate with respect to the item only if it is made on the return for the taxable year in which the item arises or in a statement attached thereto. In such a case, disclosure with respect to the item is not required on the return for the taxable year in which the carryover or carryback attributable to the item is taken into account.

(e) *Pass-through entities.* In the case of items attributable to a pass-through entity ("pass-through items"), disclosure regarding the tax treatment of such items should be made on the return of the entity or on an attachment thereto. For this purpose, a pass-through entity is a partnership, an S corporation (as defined in section 1361(a)(1)), an estate, a trust, a regulated investment company (as defined in section 851(a)), or a real estate investment trust (as defined in section 856(a)). A taxpayer (partner, shareholder, or beneficiary) also may make adequate disclosure with respect to a pass-through item, however, if the taxpayer files a separate statement in duplicate, one copy attached to and filed with the taxpayer's return and the other copy filed with the Internal Revenue Service Center with which the return of the entity is required to be filed. Each statement filed shall relate to the pass-through items of only one entity and shall include the following:

(1) An identification of the taxpayer and the entity by name, address, and taxpayer identification number.

(2) The taxable year of the entity to which the disclosure relates.

(3) An identification of the items with respect to which the taxpayer has made disclosure under this paragraph.

(4) Such additional information as would be required for adequate disclosure with respect to the items under paragraphs (a), (b), and (d) of this section.

(5) A notation to the effect that the statement is to be associated with the return of the entity.

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§ 1.6661-5 Items relating to tax shelters.

(a) *In general.* (1) Tax shelter items (as defined in paragraph (c) of this section) are treated as if such items were shown properly on the return for the taxable year in computing the amount of tax shown on the return if—

(i) There is or was substantial authority for the tax treatment of the items (as provided in § 1.6661-3); and

(ii) The taxpayer reasonably believes at the time the return is filed that the tax treatment claimed is more likely than not the proper tax treatment of the items (see paragraph (d) of this section).

Thus, for purposes of section 6661, the tax attributable to such items is not included in the understatement for the year. (See paragraph (d)(2) of § 1.6661-2.)

(2) Disclosure (whether or not adequate under § 1.6661-4) with respect to tax shelter items (as defined in paragraph (c) of this section) does not affect the amount of the understatement.

(b) *Tax shelter*—(1) *In general.* For purposes of section 6661, the term "tax shelter" means—

(i) A partnership or other entity (such as a corporation or trust),

(ii) An investment plan or arrangement, or

(iii) Any other plan or arrangement, if the principal purpose of the entity, plan, or arrangement, based on objective evidence, is the avoidance or evasion of Federal income tax. The principal purpose of an entity, plan or arrangement is the avoidance or evasion of Federal income tax if that purpose exceeds any other purpose. See § 1.269-3(a). Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, overvalued assets or assets with values subject to substantial uncertainty, nonrecourse financing, financing techniques which do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction. The existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter.

(2) *Principal purpose.* The principal purpose of an entity, plan or arrangement is not the avoidance or evasion of Federal income tax if the entity, plan or arrangement has as its purpose the claiming of exclusions from income, accelerated deductions or other tax benefits in a manner consistent with the statute and Congressional purpose. For example, an entity, plan or arrangement will not be considered to have as its principal purpose the avoidance or evasion of Federal income tax merely as a result of the following uses of tax benefits provided by the Internal Revenue Code: The claiming of the investment credit under section 38; the purchase or holding of an obligation bearing interest which is excluded from gross income under section 103; entering into a safe-harbor lease transaction under section 168(f)(8); taking an accelerated cost recovery system (ACRS) allowance under section 168; taking the percentage depletion allowance under section 613 or section 613A; deducting intangible drilling and development costs as expenses under section 263(c); establishing a qualified retirement plan under the provisions of sections 401-409A, claiming the possession tax credit under section 936; or claiming tax benefits available by reason of an election under section 992 to be taxed as a domestic international sales corporation (DISC), under section 927(f)(1) to be taxed as a foreign sales corporation (FSC), or under section 1362 to be taxed as an S corporation.

(c) *Tax shelter item.* An item of income, gain, loss, deduction or credit will be considered a "tax shelter item" if the item is directly or indirectly attributable to the principal purpose of a tax shelter to avoid or evade Federal income tax. Thus, if a partnership is established for the principal purposes of the avoidance or evasion of Federal income tax by acquiring and overvaluing property for the purpose of claiming the investment credit under section 38, the investment credit with respect to the property would be a tax shelter item. However, a deduction claimed in connection with a separate transaction carried on by the same partnership is not a tax shelter item if the transaction does not constitute a plan or arrangement the principal purpose of

which is the avoidance or evasion of tax.

(d) *Reasonable belief.* For purposes of section 6661, a taxpayer will be considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if—

(1) The taxpayer analyzes the pertinent facts and authorities in the manner described in § 1.6661-3(b)(3) and, in reliance upon that analysis, reasonably concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld in litigation if the claimed treatment is challenged by the Internal Revenue Service; or

(2) The taxpayer in good faith relies on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in § 1.6661-3(b)(3) and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld in litigation if the claimed tax treatment is challenged by the Internal Revenue Service.

(e) *Pass-through entities.* In the case of tax shelter items (as defined in paragraph (e) of this section) attributable to a pass-through entity (as defined in § 1.6661-4(e)), the actions described in paragraphs (d) (1) and (2) of this section, if taken by the entity, will be deemed to have been taken by the taxpayer and will be considered in determining whether the taxpayer reasonably believes that the tax treatment of an item is more likely than not the proper tax treatment.

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§ 1.6661-6 Waiver of penalty.

(a) *In general.* The Commissioner may waive all or part of the penalty imposed by section 6661 on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith. The circumstances taken into account in determining whether to waive the penalty are described in paragraph (b) of this section. In addition, paragraph (c) of this section describes circumstances in which the penalty will always be waived.